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IFRS Project Insights

Financial Instruments: Hedge Accounting

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The Financial Instruments Replacement Project is split into three phases: Classification and Measurement, Impairment and Hedge Accounting. In November 2009, the IASB published IFRS 9 *Financial Instruments* that includes guidance on classification and measurement of financial assets. In November 2010, the IASB issued amendments to IFRS 9 on the measurement of financial liabilities and carried forward the derecognition guidance contained within IAS 39 *Financial Instrument: Recognition and Measurement*. The IASB is currently deliberating the comments received on their impairment proposals.

The objective of the hedge accounting phase is to improve the decision-usefulness of hedge accounting and simplify the requirements that allow designation of hedge-accounting relationship. The hedge accounting project consists of two phases: 1) the general hedge accounting model and 2) the macro (e.g., portfolio) hedge accounting model. On 9 December 2010, the IASB issued ED/2010/13 *Hedge Accounting* proposing several changes to the general hedge accounting model. The comment period on the ED closed on 9 March 2011. The IASB began redeliberations on the proposals in the ED in April 2011.

Summary of tentative decisions on macro hedge accounting

- The Board tentatively decided to develop a macro hedge accounting model that would permit designation of a "bottom layer" within a portfolio rather than a proportional amount of the entire portfolio as the hedged item.
- The Board asked the staff to further explore two macro hedge accounting approaches. The first approach would accept a risk management approach including risk management policies while the second approach would accept a risk management approach but restrict entity specific risk management policies. The Board asked the staff to hold a future education session to review some of the 'non-GAAP' measures currently being used in practice as proxy's for financial reporting of macro hedging strategies.

Tentative decisions reached during redeliberations on general hedge accounting

Eligible Hedged Items

- The Board tentatively decided to expand the scope of eligible hedge items to also include equity investments designated at fair value through OCI under IFRS 9 (the ED had limited eligible hedged items to those impacting profit or loss). Any ineffectiveness resulting from the hedging relationship would be recognised in OCI. However, the Board did not extend the scope of eligible hedged to other items impacting OCI beyond those equity investments designated at fair value through OCI. The Board tentatively decided to retain the restriction in the ED regarding designation of risk components which exceed the total cash flows of the hedged items (the 'sub-LIBOR issue').
- The Board tentatively decided to retain the notion of risk components as eligible hedged items using a criteria approach. The identification of eligible risk components would be based on the hedged item being separately identifiable and reliably measurable for both financial and non-financial items. The final standard would provide guidance on the application of these criteria using the following new examples: commodity price risk related to coffee purchases, price risk related to jet fuel purchases and the fair value interest rate risk of a fixed rate bond. The ED's example of contractually specified risk components in a natural gas contract would also be included in the final

standard. The Board tentatively decided to expand the 'sub-LIBOR' example from the ED to also include a commodity hedge to illustrate the issues applicable to a market for a non-financial item.

- The Board tentatively decided to eliminate the restriction in the ED that would have prohibited the designation of inflation risk as an eligible hedged item. A 'rebuttable presumption' and a 'caution' related to non-contractually specified inflation risk components would be included in the final standard. The Board also tentatively decided to include examples of an inflation risk component being eligible and not being eligible for designation as a risk component.

Eligible Hedging Instruments

- The Board tentatively reaffirmed the proposal in the ED to permit cash instruments measured at fair value through profit or loss as eligible hedged items. The Board considered requests from constituents to expand the scope of eligible hedging instruments to all cash instruments (including those measured at amortised cost) but did not support further expanding the scope. However, the Board tentatively decided to clarify that financial liabilities designated under the 'fair value option' where part of the change in the fair value of the liability is recognised in OCI would not be eligible hedging instruments.
- The Board tentatively decided to permit a combination of a written and a purchased option, regardless of whether the instrument arises from a single or multiple contracts, as an eligible hedging instrument unless the combination results in a net written option.

Fair Value Hedges

- The Board tentatively decided that fair value changes of the hedging instrument and the hedged item would be taken immediately to profit or loss as is currently required by IAS 39, rather than OCI which was proposed in the ED, with elevated disclosure in the notes to the financial statements that provide the extent of risk management activities and offsetting achieved by hedges. Disclosures will be deliberated in a future meeting.
- The Board tentatively decided that the gain or loss on the hedged item attributable to the hedged risk should be reflected as an adjustment to the carrying amount of the hedged item as is currently required by IAS 39, rather than as a separate line item in the statement of financial position which was proposed in the ED, with disclosure of the fair value hedge adjustment in the notes to the financial statements.
- The Board tentatively decided to not allow the use of linked presentation for the purposes of hedge accounting.

Assessment of Hedge Effectiveness

- The Board tentatively decided (subject to editorial changes) to supplement the term 'other than accidental offsetting' by clarifying that a hedging relationship would have to meet the following two criteria: (1) that there is an economic relationship between the hedged item and the hedging instrument, and (2) the effect of credit risk on the hedging instrument does not dominate the value changes that result from the economic relationship (i.e., the effect of the changes in the underlying).
- The Board tentatively decided (subject to editorial changes) to replace the guidance in the exposure draft on 'unbiased hedge', 'minimising hedge ineffectiveness', and that 'the entity has no expectation that changes in the value of the hedging instrument will systematically either exceed or be less than the changes in value of the hedged item such that they would produce a biased result'. Instead, the guidance would include criteria that an entity's designation of the hedging relationship shall be based on (1) the quantity of hedged item that it actually hedges, and (2) the quantity of the hedging instrument that it actually uses to hedge that quantity of hedged item. Guidance would also be included that an entity shall not designate a hedging relationship such that it reflects a deliberate mismatch between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness in order to achieve an inappropriate accounting outcome.

Rebalancing and Discontinuing the Hedging Relationship

- The Board tentatively decided to align the rebalancing guidance with the Board's tentative decision on the hedge effectiveness assessment approach such that after the inception of a hedging relationship, rebalancing would occur when an entity adjusts the quantities of the hedging instrument or the hedged item in response to changes in circumstances that affect the hedge ratio of that hedging relationship. However, the hedging relationship for hedge accounting purposes would have to use a different hedge ratio than for risk management purposes if:
  - the adjustments for risk management purposes would result in a hedge ratio that would reflect an imbalance that would create hedge ineffectiveness in order to achieve an accounting outcome that is inconsistent with the purpose of hedge accounting, or
  - for risk management purposes an entity would retain a hedge ratio that in new circumstances would reflect an imbalance that would create hedge ineffectiveness in order to achieve an accounting outcome that is inconsistent with the purpose of hedge accounting (i.e., an entity must not create an imbalance by omitting to adjust the hedge ratio).
- The Board tentatively decided to retain the prohibition in the ED that voluntary discontinuation of hedge accounting would not be permitted if the risk management strategy and objective had not changed. However, additional guidance will be included for instances where hedge accounting is a 'surrogate' for portfolio hedging (e.g., banks managing their loan books for interest rate risk when the characteristics of the loan portfolio are constantly changing) and for hedging relationships that at a specific stage automatically convert to a natural hedge (e.g., hedging foreign currency risk for forecast sales or purchases denominated in a foreign currency). The final standard will also include enhanced guidance on risk management strategy and risk management objective (i.e., risk management strategy is the entity wide approach for managing risk where as risk management objective is the transactional level application of the hedging relationship).

Accounting for the Time Value Associated with Options

- The Board tentatively decided to align the accounting for zero-cost collars (a combination of purchased and written options, one being a put and one being a call option with a net nil time value at inception) and the time value of options, given that zero-cost collars provide for fluctuating time value components over the life of the hedging relationship.

- The Board tentatively decided to retain the EDs proposed accounting model for the time value of options (the 'insurance premium view'), but provide additional guidance on differentiating between transaction related and time period related hedged items and that the amortisation period does not necessarily have to correspond to the period of the hedging relationship but rather to the period over which the hedge adjustment for intrinsic value can affect profit or loss.

- The Board tentatively decided not to provide an overriding principal supporting the accounting treatment for the time value of options as they felt doing so would inevitably require creating exceptions to the principal in order to address all scenarios (particularly firm commitments).

- The Board tentatively decided to require the proposed accounting treatment rather than permit it as an accounting policy choice (which would have also continued to permit the current practice of recognising the time value component as a separate financial instrument carried at fair value through profit or loss).

- The Board tentatively decided to permit the recognition of forward points that exist at inception of a hedging relationship in profit or loss over time on a rational basis and accumulate subsequent fair value changes in accumulated other comprehensive income (consistent with the approach for the time value of options).

Nominal Components - Layers

- The Board tentatively decided to permit a layer-based designation of a hedged item when the item does not include a prepayment option whose fair value is affected by changes in the hedged risk. The Board also tentatively decided that:

- for partially prepayable items, a layer-based designation of the hedged item should be allowed for those amounts that are not prepayable at the time of designation;
- a designation of a layer as the hedged item should be allowed if it includes the effect of a related prepayment option when determining the change in fair value of the hedged item.

- The Board tentatively decided not to differentiate written and purchased prepayment options for the purpose of the eligibility of layer-based designation of hedged items.

Groups and Net Positions

- The Board tentatively decided to the following:
  - reconfirm the proposal in the exposure draft allowing designation of an aggregated exposure as an eligible hedged item,
  - include illustrative examples in the final standard,
    - to clarify (1) in the final standard that derivatives that form part of an aggregated exposure are always recognised as separate assets or liabilities and measured at fair value, and (2) in the basis for conclusions that the Board noted that accounting for aggregated exposures is part of hedge accounting and different from 'synthetic accounting',
  - not impose any specific restrictions regarding the non-derivative original exposure and the derivative that form the aggregated exposure to be an eligible hedged item, and
  - to provide additional clarification to the final standard by:
    - expanding the description of an aggregated exposure to include a highly probable forecast transaction of an aggregated exposure if that aggregated exposure once executed is eligible as a hedged item, and
    - adding application guidance (1) that the way in which a derivative is designated as a hedged item as part of an aggregated exposure must be consistent with any designation of that derivative as the hedging instrument at the level of the aggregated exposure, and (2) that otherwise a derivative must be designated in its entirety or as a percentage of its nominal amount.
- The Board tentatively decided to extend the eligibility for designation as a hedged item to net positions involving forecast transactions that affect profit or loss in different period when hedging foreign exchange risk.
- The Board tentatively decided that for a hedge of a group of items with offsetting hedged risk positions that affect different line items in the income statement (net position hedges) to present the reclassification of gains or losses on hedging instruments in a separate line item in the income statement without adjusting the line items affected by the forecast transactions.

Other Items

- To address the issue of hedging credit risk using credit derivatives, the Board tentatively decided to permit an elective fair value through profit or loss (FVTPL) accounting for credit exposures such as loan and loan commitments at or subsequent to initial recognition of the financial asset and such an election would be permitted for a component of nominal amounts (rather than the entire nominal amount). The Board also tentatively decided on 'Alternative 2' of the FVTPL accounting variations. Under this alternative, the 'measurement change adjustment' (MCA) is recognised immediately in profit or loss and therefore on discontinuation of FVTPL accounting the fair value of loans becomes the new deemed cost and there is no MCA.

- The Board also tentatively decided to require disclosures when electing this FVTPL approach including 1) a reconciliation of the nominal amount and the fair value of the credit derivatives that have been used to manage the credit exposure of a financial instrument that qualified and was elected for FVTPL accounting, 2) the gain or loss recognised in profit or loss as a result of electing FVTPL accounting for a credit exposure, and 3) for discontinuation of elective FVTPL for credit exposures the fair value that becomes new deemed cost or amortisable amount (for loan commitments) and the related nominal or principal amount.

- The Board tentatively decided to replace the 'own-use' exception proposal in the ED by extending the IFRS 9 fair value option to contracts that meet the 'own-use' scope exception if doing so eliminates or significantly reduces an accounting mismatch.

Disclosures

- The Board tentatively decided to reconfirm the proposal in the ED that hedge accounting disclosures would be presented in a single note or section of the financial statements but information presented elsewhere (e.g., management commentary or risk reports) need not be duplicated but rather incorporated by cross reference. The current IFRS 7 requirement to describe any forecast transactions that have been designated as hedged items in prior periods but which are no longer expected to occur would be included in the final standard.
- The Board tentatively decided to reconfirm the scope of the hedge accounting disclosures in the ED that would require disclosure for only those risks that an entity manages as part of its risk management strategy and where hedge accounting is applied.
- The Board tentatively decided to reconfirm the proposal in the ED that would require an entity to disclose information on its risk management strategy for each category of risk that enables users to evaluate (1) how each risk arises, (2) how the entity manages each risk (including hedging the whole or a risk component) and (3) the extent of the exposures that the entity manages. The final standard would also include application guidance on the types of information to be provided to meet the disclosure objective such as (1) whether the entity hedges an item in its entirety for all risks or hedges a risk component of an item and how each risk arises, (2) the hedging instrument that is used to offset the risk exposure, (3) how the entity determines the economic relationship between the hedged item and the hedging instrument for the purposes of testing hedge effectiveness, and (4) how the entity establishes the hedge ratio and the sources of hedge ineffectiveness. Additionally, when risk components are designated as hedged items, an entity should provide information about the determination of the component and how the component relates to the item in its entirety.
- The Board tentatively decided not to prescribe a specific level of aggregation or disaggregation for the hedge accounting disclosures but entities should be consistent with the level of aggregation used for the IFRS 7 and IFRS 13 disclosures. The tabular disclosure requirement in the ED was also reconfirmed but the Board tentatively decided to add additional columns that provide information on (1) the location of the line item that includes the designated hedged item and hedging instrument in the statement of financial position and (2) changes in the fair value of the hedged item and the hedging instrument used to calculate the hedge ineffectiveness. The Board also tentatively decided to not introduce a disclosure requirement specifically for distinguishing between financial instruments that have been designated as hedging instruments and those that have not.
- The Board tentatively decided to limit the scope of the ED's proposed disclosures regarding the amount, timing and uncertainty of future cash flows to require only disclosure of information that would allow users to understand the notional amount of the hedging instrument, a profile of its timing, and if applicable, the average price or rate of the hedging instrument. The Board tentatively decided to exempt dynamic hedging relationships from the requirement to disclose the terms and conditions of the hedging instrument. Instead, the Board tentatively decided that for those entities that use such a hedging strategy, the description of their risk management strategy would be expanded by providing 1) information about the ultimate risk management strategy, 2) a description of how it meets that objective by using hedge accounting and designating the particular hedging relationships, and 3) an indication of how frequently the hedging relationships are discontinued and restarted as part of the dynamic process. Additionally, entities would disclose, if applicable, the fact that the volumes of hedging relationships for dynamic hedging processes were not representative of normal volumes throughout the year.

Effective Date and Transition

- The Board has proposed to delay the mandatory effective date of IFRS 9 until annual periods beginning on or after 1 January 2015. The Board has issued an exposure draft proposing the delay with the comment period closing on 21 October 2011. The proposal would still permit early application of IFRS 9. The Board tentatively decided that the mandatory effective date of the new hedge accounting model will be aligned with the effective date of IFRS 9.
- The Boards tentatively decided that the transition to the new model would be prospective with certain exceptions. Retrospective application of the new model would not be permitted 1) if it would involve retrospective designation, 2) for designation of risk components, 3) for aggregated exposures, and 4) for groups and net positions. However, the Board tentatively decided that retrospective application would be

required for the time value of options whose intrinsic value had previously been designated as a hedging instrument. Also, the Board tentatively decided that retrospective application would be permitted for hedging relationships in which the hedging instrument is designated as the spot element of a forward contract. The Board decided that if an entity elects retrospective application it would have to be applied to all hedging relationships of this type (i.e., the accounting is not available on a hedge-by-hedge basis). To address concerns over the time lag between stopping use of the IAS 39 hedge accounting model and applying the new hedge accounting model and the potential for changes in market values, the Board tentatively decided to include clarifying guidance that entities can consider for transition purposes 'the same logical second' when transitioning between hedge accounting models.

- The Board tentatively decided that for purposes of rebalancing a hedging relationship, the ratio used under IAS 39 would be the starting point and entities would 1) recognise all the ineffectiveness in retained earnings at the transition date, 2) rebalance the hedging relationship and accounting for as a continuing hedge, and 3) recognise any gain or loss arising from the rebalancing of these hedging relationships in profit or loss.

Next steps

The Board decided re-exposure of the tentative decisions was not necessary and intends to post a staff draft of the hedge accounting portion of IFRS 9 to its website during the fourth quarter of 2011 which will be available for 90 days. The FASB will be provided an opportunity to consider the decisions made by the IASB so the FASB can decide how to best proceed with their own hedge accounting project.

The IASB has now shifted its attention to the portfolio hedge accounting portion of the project. The IASB expects to publish an ED for macro hedge accounting in the fourth quarter of 2011 or early 2012.

Convergence

The FASB issued their own proposals on hedge accounting in their proposed ASU *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*. The proposals on hedge accounting were largely similar to the proposals originally included in the exposure draft, *Accounting for Hedging Activities* issued in June 2008.The FASB's proposals on hedge accounting include, among other things, an effectiveness threshold of 'reasonably effective' and permitting qualitative assessments of hedge effectiveness, elimination of the 'shortcut' and 'critical-terms-match' concepts, and not permitting voluntary de-designation. Designating a risk component of a non-financial item would still not be permitted.

In February 2011, the FASB also issued a Discussion Paper – *Invitation to Comment – Selected Issues about Hedge Accounting* requesting US constituent feedback on the IASB's hedge accounting proposals. Comments were due by 25 April 2011.

Thinking ahead

- The IASB has considered two primary objectives as part of the amendments: reducing the complexity associated with applying hedge accounting and more closely aligning hedge accounting with an entity's risk management processes. In attempting to more closely align hedge accounting with the risk management processes, the IASB has tentatively agreed on certain "rules" to attempt to limit potential abuses. However, the inclusion of these rules may offset some of the IASB's simplification efforts.
- As a result of the IASB's intention to better link the risk management policies of an entity to the hedge accounting process, entities may need to enhance their documentation and controls around the risk management process.
- The allowance of risk component designation for non-financial hedged items that are separately identifiable and reliably measurable may help to reduce some of the accounting mismatches created under IAS 39 where the accounting did not appropriately reflect the risk management strategy
- Many companies use portfolio hedging as part of their risk management strategy, so their operational issues with applying hedge accounting may not be addressed under these proposals

- The “highly probable” threshold for hedging forecast transactions was not reconsidered as part of the proposals; therefore entities will still have a high hurdle to achieve hedge accounting of forecasted transactions
- For fair value hedges, entities will need to track the amounts to be reclassified from the separate line item valuation allowance to profit or loss. Although hedged items would no longer need to be remeasured, entities would be required to determine how and when the hedged risk impacts profit or loss in order to ensure the amounts initially recognised in the valuation allowance are reclassified appropriately to profit or loss in the correct period.
- The proposals do not permit elective dedesignation of hedge accounting without a change to the underlying risk management strategy, so once an entity decides to designate hedge accounting it must be prepared to do so for the life of the hedging relationship
- Entities considering designating equity investments at fair value through other comprehensive income upon adoption of IFRS 9 should consider any impact the proposed prohibition from hedge accounting that these items may have on their risk management and financial reporting.

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